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SUBJECT: RRT ERBIL: IMPROVING BUDGET EXECUTION IN THE KRG

REF: Baghdad

This is an Erbil Regional Reconstruction Team (RRT) cable.

¶1. (SBU) SUMMARY: Acknowledging deficiencies in public finance management, the Kurdistan Regional Government (KRG) has committed to an ambitious UNDP-supported Public Finance Management Plan for improving transparency, planning execution and oversight. While the project is aligned with the national Public Finance Management Action plan and has elements which link the KRG budget process more closely to the GoI budget, it does not specifically address the issue of late and unpredictable transfers from the GoI which are a significant obstacle to KRG budget planning and execution. The KRG has committed \$500,000 of its own resources to the \$4.5 million project; the World Bank has also agreed to fund \$2 million. A budget gap of \$2 million must still be met. U.S. funding for this project would support an important step towards increasing transparency and accountability - important anti-corruption and good governance indicators for the Kurdistan Region. End summary.

#### Public Finance Management Action Plan

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¶2. (U) The KRG invited donors and other international organizations on May 6 to witness the signing of the KRG's Regional Public Finance Management Action Plan and the roll-out of UNDP's \$4.5 million Budget Execution Support Project which underpins the Action Plan.

¶3. (U) Described as a complement to the GoI Financial Management Plan (which has some overlap, but does not specifically address the needs in the the KRG), the three-year KRG PFM Action Plan acknowledges serious weaknesses in the current public finance system (see paras 6-12 for discussion) and aims to strengthen internal and external control systems and increase accountability over the use of public resources. Areas addressed are budget policy, planning and formulation, budget execution, public procurement and payment systems, public finance reporting and controls and building sustainable capacity in public finance management. Donor countries will be invited to sit on a KRG PFM Advisory Board.

#### GoI-KRG cooperation on Public Finance Management

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¶4. (U) Mr. Adhmed Mahdi of the Baghdad Ministry of Planning Development and Coordination signed a Memorandum of Understanding between the GoI and the KRG in which both sides agreed to implement their respective PFM Action plans, collaborate to mobilize resources and technical assistance and establish a Joint PFM Working Group. In his comments Mr. Mehdi noted areas of convergence with the KRG, including the KRG's commitment to use the central government Budget Call Circular being developed and the KRG's commitment to implement the new GoI procurement law and regulations, which should be approved soon in the Council of Representatives.

#### Funding from KRG and World Bank

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¶5. (U) The KRG announced that it would commit \$500,000 of its own resources as well as additional in-kind contributions to the UNDP project. World Bank country Director Jean Michelle Happi noted that a USD 20 million facility was funding the national PFMAP and announced that the World Bank would cover \$2 million of the KRG project. Mr. Happi stated that where elements of the KRG PFM's

action plan overlapped with the GoI's PFM items, the World Bank would provide assistance, financial and technical, to ensure these items are fully integrated. Other donors (France, Germany, Japan, Korea, US, Italy) expressed support for the project's aims, and promised to study the proposal. (Note: UNDP has already committed \$850,000 "Trac-1" resources to the project preparation.)

#### Weaknesses in KRG Financial Management

¶16. (U) The Kurdistan Regional Government (KRG) derives over 97 percent of its revenues from transfers from the Central Government and shares the GoI's vulnerability to fluctuating oil prices. Transfers are made up of the Divisible Pool (the Region's 17% share of the Federal Budget after deduction for in-kind transfers and sovereign expenditures), In-kind Expenditures (food basket, fuel, pharmaceuticals), the Regional Development Fund (of which the KRG receives only 11.3 percent of the total fund) and the Regional Development Banking Fund. KRG authorities claim that earmarked fuel subsidies and some food ration subsidies have been withheld.

¶17. (U) The KRG collects revenues from customs at the borders of Turkey and Iran, and to a lesser extent from rent incomes and fees. Revenues were estimated at \$162 million in 2007 and \$177 million in 2008 (less than 2.2 percent of transfer levels.) In 2007 the Central Government deducted estimated customs revenues from the KRG's 17% transfer.

#### Expenditures

¶18. (U) Wage bills and non-wage recurring expenditures accounted for over 65 percent of total KRG spending in 2007 - putting heavy

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pressures on fiscal sustainability and contributed to crowding out capital expenditures. (The urgent need to reform the civil service and provide an alternative "social safety net" is not addressed in the UNDP project, but has been highlighted elsewhere by KRG leaders as a priority. )

#### Deficiencies in planning, execution and oversight

¶19. (U) Kurdistan Regional strategies and policies are not linked to KRG budget planning and execution, leading to mismatches between what is promised and what is affordable. In addition, according to UNDP, capital budgets are subject to political priorities identified by the KRG Council of Ministers without clearly identified rules and priorities. Execution is also heavily disadvantaged by the uncertainties of the timing and amounts of transfer and cash flows released to the KRG's Central Bank from the Central Bank of Iraq, making it difficult for ministries to effectively plan and implement programs. The KRG Ministry of Finance has reported that average delays exceeded three months during 2008. The KRG Authorities have reportedly sought cooperation from the Central Ministry of Finance and the CBI to make cash flows available at the beginning of the month based on clearly defined policy, in order to be able to plan and execute the budget more accurately.

¶10. (U) According to the UNDP analysis, the KRG operates a cash-based system of accounting which does not fully identify, capture and record commitments. Reporting is limited to preparation of trial balance which is essentially a book balancing tool. Oversight and internal controls are carried out within each spending unit by internal auditors. However, procedures are not clear, predictable or standardized.

#### Board of Supreme Audit

¶11. (U) The KRG Board of Supreme Audit (BSA) provides overall guidance for maintaining a system of internal controls and conducts the external audits after the implementation of the budget. However, the BSA does not receive the consolidated financial statements transmitted to the Kurdistan Parliament by the KRG Ministry of Finance in a consistent and timely fashion, which has caused delays in auditing accounts. Although plans are underway for unification,

the existence of two BSA structures (one in Erbil and one in Sulaimaniyah) stand in the way of a unified procedure and auditing framework for the region. Other challenges facing the BSA relate to the lack of qualified staff; the need to upgrade auditing practices in order to meet sound international standards; and the need to affiliate the BSA with regional and international auditing institutions, such as INTOSAI, ARABSAI and ASOSAI.

#### Procurement

¶12. (U) Public procurement in KRG broadly follows Iraq's national standards. According to UNDP, current procedures have a number of features that are not in line with generally accepted standards of good practice. These range from inadequate requirement for registration of suppliers and contractors, an absence of adequate bidding documents to insufficiently transparent bid submission, opening and evaluation procedures, and contract award procedures as well as lack of effective bid protest mechanisms and publicity on contract awards. However, a new procurement law and standard bidding documents are now being developed at the national level. The draft law and regulations (which the KRG will follow) were signed off by the Government of Iraq in 2008 and are under review by the Shura Council, before being submitted to Parliament for approval.

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¶13. (SBU) Like the rest of Iraq, the Kurdistan Region must adapt to the fact that oil price fluctuation will always impact planning, and must put in place mechanisms to "smooth out" year to year volatility. But the region faces an additional challenge, the fact that cash transfers are late and unpredictable, and the region's budget must always wait on the final Baghdad budget numbers. Most of these problems can be mitigated by preparing contingencies, and improving planning, but it is clear that discussion between Baghdad and Erbil on these issues needs to be deepened in order to put in place better mechanisms. The MOU signed on May 5 may be a useful first step, but we note that the key player on these issues - the Ministry of Finance - was not present at the meeting.

¶14. (SBU) The USG has provided relatively little support to the KRG to improve public finance management (primarily Brinkley Task Force-funded procurement support) and nothing to support anti-corruption activities. Funding the UNDP project either directly or through in-kind contributions would support an important step towards greater professionalism, transparency and accountability in KRG budget execution - objectives which are key to larger USG goals of good governance for the region. We strongly urge consideration of such support.

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